Finding Your Appetite

Defining the 'risk appetite' of an institution is suddenly fashionable – but what should this mean in practice?

In our personal lives a big shock can make us question the basics of our life – what are we actually trying to do and are we going about it in the right way?

The banking industry is no different. One of the key reactions to the 2007-9 credit crunch has been a desire to look again at how banks formulate and express their appetite for risk.

The fear is that if banks don't answer this fundamental question more rigorously their whole business strategy and risk management program might set off on the wrong foot.

But making a clear statement about a bank's risk appetite isn't as easy as it sounds. There's a danger the industry will soon be peppered with woolly statements about risk that are as useful as a half-baked mission statement.

How can executives set out a risk appetite that does some real work for the enterprise?

Set out the purpose of the risk appetite

A good place to start is with the fundamental purpose of any statement about risk appetite, which we think is communication in two different directions (Figure 1).

First, the bank needs to tell an external audience how much risk the bank intends to take so that investors and others can interpret the bank's performance in the light of its intended risk and return profile – and compare the performance and profile to that of other institutions.

Second, the bank needs to tell its internal audience how much risk they can assume in ways that are meaningful at the level of the business line and individual risk control functions.

Communicating clearly with external audiences is important because bank financial statements are hard to interpret. It's up to the bank to tell investors what its main risks are on and off balance sheet, the attitude it takes to managing catastrophic risks, and to characterize how it seeks to balance risk and reward through its business strategy.

It's important to be straightforward with investors. Promising a very conservative attitude to risk along with high returns and an

Figure 1: Your risk appetite sends information in two directions

exciting increase in market share through the economic cycle may not make sense.

Likewise, if the purpose is communication, any philosophical statements about risk appetite must be tied to something tangible and comparable such as, "We intend to maintain the same level of solvency risk as a traditional corporation rated A by the rating agencies".

Without an objective point of reference like this, a description of the bank's risk appetite won't mean anything when the bank's external audience compares it to similar-sounding statements of intent.

Pledges on catastrophic risk can also help. Does the bank commit to inform investors of catastrophic tail risks inherent in its business model, however improbable they seem – in line with the 'reverse stress testing' concept now being promoted by some regulators?

An old confusion: Which kind of risk is on the menu?

It's tempting to define risk appetite as the amount of risk that an organization is prepared to accept in pursuit of its goals.

But does the 'risk' here refer to the bank's tolerance of earnings volatility, or the largest unexpected loss the bank could stomach and remain solvent?

Both of these 'risk appetites' are of legitimate interest to different people, e.g., equity investors and senior debtholders, but they have a complicated connection to one another. A bank determined to keep earnings stable might achieve this by taking on more solvency risk.

A good way to cut through the potential confusion is for the bank to set out what it means by risk appetite using economic capital concepts, e.g., is the bank talking about a one-standard deviation risk or a two-standard deviation risk? For an external audience, a more accessible way to say the same thing is to link the discussion to the chance that losses will overwhelm concentric levels of bank defense (Figure 2).

For the bank's various audiences, how small must this chance be, for each defense? Do executives need to add some additional safety margin on top of that apparent risk tolerance?

A new confusion: Does capitalized risk matter?

This opens up another question. Suppose a bank takes on a lot of 'risky' business (e.g., low FICO/high LTV mortgages), and then capitalizes this risk conservatively. Does this bank have a high or low risk appetite?

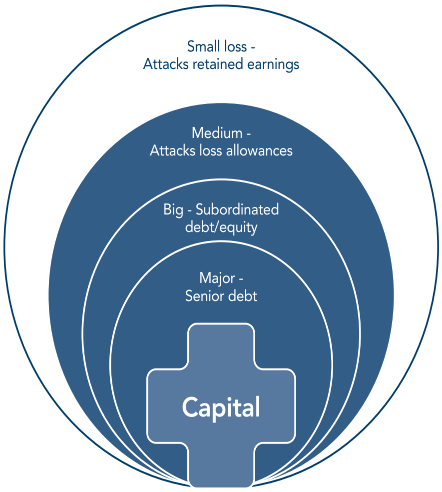
The easy answer, according to the logic we set out above, is that if capital defenses are high enough, the bank can claim to have a low appetite for solvency risk.

The easy answer isn't quite good enough. Banks can aim to defuse risk concentrations using capital. But there are bound to be some uncertainties underlying the capital calculation, and these uncertainties matter more with some kinds of risk than others.

Sensitivity testing of the parameters of the bank's economic capital model, and wider-ranging stress tests, will help reveal just how dependent the bank's solvency is on modeling assumptions. However, an apparently well-capitalized bank with major enterprise-level risk concentrations that allows itself to become too dependent on immature risk models, or too reliant on the risk assessments of third parties, will never look low risk to well-informed investors.

So the answer must be that while capital counts, it is not the end of the risk communication story, particularly where there are enterprise and business model risk concentrations.

Figure 2: What kind of risk are we talking about?



Operationalizing the bank's risk appetite

The risk appetite that the bank communicates to investors must also be operationalized within the bank. Line managers need to know what the bank expects of them and the nature and volume of business they can do.

Too often, however, banks try to specify this simply in terms of limits, the 'speed traps' of bank risk management.

Business volume limits and limits based on risk estimates are important, but they must be given meaning by setting out a more basic framework or 'rules of the road'.

Depending on the bank's activities, these rules of the road might include policies on reporting risk, basic rules of behavior, the way the bank approaches each key risk, the level of certainty it places on different kinds of risk limit, and places the bank simply won't go. For example:

- Rules of behavior might set out new product approval processes, and also stipulate that employees must reconsider 'unlikely seeming' risks as a business grows and generates enterprise threatening risk concentrations

- No-go areas might be defined in geographic, risk segment, or product terms such as a list of derivative instruments that can be employed in a given market

- For each type of risk, the bank must choose the right mix of limit type for expressing the bank's risk appetite. How good are notional limits at capturing economic risk in certain areas? Do quantitative risk limits such as those based on Value at Risk or economic capital really capture all the enterprise threats created by a particular activity?

- What is the relationship between a limit, expected limit usage, actual usage, and limit monitoring - and is this consistent across the enterprise?

Without some rules of the road of this kind, speed traps will be easy to drive around and the bank's periodic estimates of how its risk taking compares with its risk appetite may prove meaningless.

This is particularly true if the bank lets a big gap open up between the message it sends to line managers through its limits framework, and how it measures and rewards their performance. For example, are business performance and incentive compensation determined on a risk-adjusted basis and, if so, which risks are counted and which are not? Banks need to make sure that their business drivers, as well as their risk limits, are congruent with the bank's risk appetite.

When setting limits and drivers, economic capital can be a big help because it offers an objective risk metric that is designed to balance risk and return in the light of the bank's solvency target. A system of economic capital-based limits will help the bank make sure its local limits are in line with the bank's overall risk appetite, and that limits remain congruent with each other across different business areas and risk types such as credit, market and operational risk.

Importantly, best-practice economic capital can take account of enterprise correlation and concentration risks in a sophisticated way, so that local limits properly reflect the risk that local business expansion contributes to the whole enterprise.

This is not, however, to argue that economic capital is the 'solution' to operationalizing the bank's risk appetite. It's one important tool in what will, inevitably, be a more complex mix of policy, process, qualitative information, notional measures and management judgment.

But to make use of economic capital models we have to guard against some dangers, and the biggest is to apply the numbers without using judgment and constant monitoring.

What if things go wrong?

Finally, banks must set out some kind of 'playbook' for what will happen if the bank looks likely to contravene its risk appetite statement.

A contravention might be deliberate, e.g., when the bank plans a risky M&A that is in its shareholders' long-term interests but that creates short term risks that are out of line with the bank's stated risk appetite.

It might also happen inadvertently when the bank realizes it has mis-estimated the risk associated with an activity, as the result of macroeconomic shocks, when a hidden enterprise risk concentration comes to light, or when there is accidental limit breaking or deliberate misdemeanor by a business line.

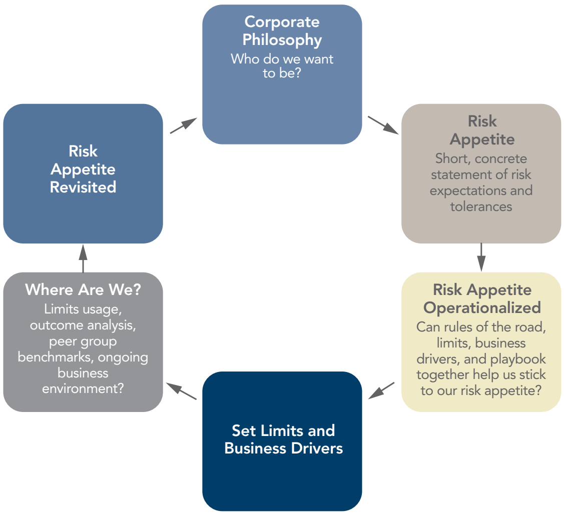
The playbook should set out how the bank will deal with the situation in terms of communicating with investors, raising more capital and reducing risk within a reasonable timetable.

Figure 3 sets out the overall process for operationalizing a bank's risk appetite for its internal audience.

Conclusion: Getting your appetite back

Statements about risk appetite need to be put to work rather than left on the shelf gathering dust. The process of establishing the bank's risk appetite should itself be used to generate valuable discussions between the bank's risk and business experts, bank executives, and the bank's board.

Figure 3: Finding your appetite



The bank's risk appetite must then be widely communicated and used as a touchstone in all sorts of day-to-day business decisions throughout the bank, as well as for strategic planning. For example, how does a developing strategy or planned acquisition fit with the bank's risk appetite? What are the implications of the evolving business cycle, e.g., will capital and business growth targets remain acceptable?

None of these questions will be easy to answer unless the bank's risk appetite has already been defined in concrete terms and made operational in a transparent and consistent way.

The good news, however, is that banks that formulate meaningful risk appetites will find they have a much stronger platform for talking to investors and winning back their confidence.

This article was contributed by Shahram Elghanayan, managing director, Ambit Risk Consulting, and the Ambit Risk Consulting team, who welcome your comments at Shahram.Elghanayan@sungard.com

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1. For industry discussion see, for example, Recommendations 1.9-1.14, Final Report of the IIF Committee on Market Best Practices, July 2008, pages 35 and 36
2. We tackled the subject of risk-adjusted compensation in the Spring edition of this report
3. Our approach to economic capital-based credit limit setting is described in 'Bank Concentration Risk – Beyond the Limit?', Jonathan York, RMA Journal, September 2007

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